

Peter Nicholl: Bosnia and Herzegovina - progress and partnership

Comments by Mr Peter Nicholl, Governor of the Central Bank of Bosnia and Herzegovina, at the second annual business conference, London, 9 December 2003.

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I would like to welcome all of you to this conference and thank you for attending.

I will cover four topics in my presentation. The first will be the Central Bank of BH and the roles it plays in maintaining financial stability in BH.

The second will be the significant improvements that have occurred in the banking sector in BH over the last three years. The third will be the changes that lie ahead of the BH financial sector in the immediate future, and I will finish with some brief comments on the economic outlook.

The central bank (CBBH)

- The CBBH commenced its operations on 11 August 1997 so it is still quite a young organization.
- It is a state level institution, which means it is the only monetary authority in BH and operates over the whole country through five offices. It has 265 staff.
- The CBBH law specifies clearly the functions that the CBBH must carry out and also sets a number of limitations on its operations.
- Subject to these legal requirements and restrictions, the CBBH is completely independent of political influence.

Monetary policy

- Monetary policy is the CBBH's most important function.
- The CBBH operates monetary policy through a strict currency board arrangement, which is stipulated in the CBBH law.
- There were three main reasons for the choice of a currency board for BH's monetary policy:
 - (a) It provided a firm nominal anchor in the form of a fixed exchange rate in a situation where there was significant economic instability;
 - (b) It removed discretion in a situation where there was considerable difficulty in establishing institutions and making political decisions;
 - (c) Currency boards had been established in some other eastern European countries and were working well.

The currency board

- The three essential features of the BH currency board are:
 - (a) A fixed exchange rate specified in the law;
 - (b) Full foreign exchange backing for all the KM liabilities of the central bank;
 - (c) Full convertibility of the CBBH's KM liabilities into the anchor currency.

The fixed exchange rate

The initial exchange rate was set at 1 KM = 1 Deutschmark (the Bosnian currency is called the Convertible Marka). The choice of the DM as the anchor currency for the BH currency board was an

easy one. The DM had long been a very stable currency and it was already widely used and trusted in BH.

When the DM was replaced by the euro, the CBBH law was changed to make the euro the anchor currency for the BH Currency Board. The new exchange rate was specified in the CBBH law at exactly the same rate as the DM had been linked to the euro. i.e., 1KM = 0.51129 euros. This means that the exchange rate of the KM has been unchanged since the CBBH commenced its operations. The transition from the DM to the euro as the anchor currency went very smoothly and the impacts on the KM and the currency board were very positive.

Full foreign exchange backing

The KM liabilities of the CBBH, which are the KM currency in circulation and the deposits of the BH commercial banks at the CBBH, have to be fully backed in convertible foreign assets. As our liabilities are tied to the euro, we hold most of our reserves in euros in order to avoid taking any exchange rate risk. The table below shows that the CBBH has maintained this full foreign exchange backing for the KM since 1998 and we had 'free reserves' of KM 148 million at the end of October, 2003.

Table 1
CBBH foreign reserves
 End of period in KM millions

Date	net foreign reserves	monetary liabilities	free reserves
Dec 1997	144.1	160.3	-16.2
Dec 1998	283.3	253.9	29.4
Dec 1999	865.7	836.7	29.0
Dec 2000	1021.2	973.2	48.0
Dec 2001	2666.6	2591.6	75.0
Dec 2002	2463.2	2345.1	118.1
June 2003	2266.1	2123.0	143.1
Oct 2003	2603.1	2455.4	148.1
Nov 2003	2634.1	n.a.	n.a.

This table also illustrates the way in which the KM gradually substituted for the other currencies that were in use in BH thus leading to a steady increase in the CBBH balance sheet from 1997 to 2000. This trend accelerated during the euro conversion period in late 2001 and early 2002. In all, the CBBH sent DM 4.3 billion of DM banknotes back to Germany from Bosnia during this conversion period and the CBBH's foreign reserves more than doubled over a four month period.

Our foreign reserves fell during 2002 and the first half of 2003 from the peak they reached at the end of 2001. Most of the fall was in the level of commercial bank deposits at the CBBH and came about mainly because banks were expanding their domestic credit rapidly and, as a consequence, they reduced the level of deposits they held at the CBBH.

The fall in the level of foreign reserves has been reversed in the last few months, primarily because of changes we made to the reserve requirement system for banks. Our foreign reserve holdings are now back over KM 2.6 billion and are close to the peak level achieved during the euro changeover period. The CBBH's net foreign reserves represent around three and a half months of import coverage, which is a 'comfortable' level.

Full convertibility

As the following table shows, the KM has been a convertible currency within BH in practice as well as in name.

Table 2

Net KM issued from 11/8/97 to 25/11/03

KM billion

KM issued to BH banks	KM purchased from BH banks	net KM issued
12.097	9.851w	2.246

The success of the currency board arrangements

The currency board has been a very successful type of monetary policy for BH:

- The KM has been a stable currency against the DM and the euro since it was introduced.
- Inflation in BH is now low and stable.

Table 3

Inflation in BH

Retail price index, annual % growth

Year ended	Federation of BH	Republika Srpska	BH average
Dec 2000	4.0	16.1	8.0
Dec 2001	0.3	2.2	0.9
Dec 2002	-0.7	2.4	0.3
Sept 2003	0.5	1.9	0.9

- KM use has risen steadily in BH and the KM is now the dominant transactions currency in all parts of the country (euros are generally accepted too, at least for larger transaction).
- The proportion of bank deposits denominated in KM is also growing, though more than 50% are still denominated in foreign currency.
- The KM has remained fully convertible in BH since it was introduced.
- The stability of the KM has been an important element in increasing the level of foreign direct investment coming into BH.

Table 4

Foreign direct investment into BH

In KM m.

period	Foreign Direct Investment
1998	117.4
1999	324.5
2000	310.1
2001	274.1
2002	604.3
2002q1 and 2	261.9
2003q1 and 2	247.8

We think that these figures actually understate the amount of foreign investment that has come into BH in the last few years. The CBBH recently initiated a survey of 800-900 companies in order to try and get more up-to-date and accurate data on foreign investment into BH.

The currency board will continue

The Presidency of BH has announced that the Currency Board Arrangements will continue as one of the major features of macro-economic policy in BH. This is also the policy of the state and entity governments as set out in the Letter of Intent they have agreed with the IMF as part of the Stand-by negotiations with the Fund.

The most important reason for this is that the policy has produced major economic and social benefits. Secondly, the citizens of BH have faced many financial traumas in the past. They therefore value a stable currency and the currency board consequently has a high level of public support within BH.

Finally, the long term goal of BH policy is to take the economy closer to and eventually into Europe. The KM is already tied to the euro. It is therefore sensible to maintain this link. The exit strategy for BH from the currency board will therefore be the eventual adoption of the euro as the currency of BH.

New board and governor of the CBBH

The CBBH law said that after the first six years of operations of the CBBH, a new Board of five Bosnian citizens would be appointed by the Presidency and that one of those five board members would be appointed Governor. This was an important transition period for the CBBH and had the potential to introduce a degree of uncertainty and possible instability. The six year date passed on 11 August, 2003. The changes have been implemented very smoothly. The Presidency appointed a new Board in April. Three of the five members already had extensive CBBH experience. With the support of the Presidency, the Board has appointed the new Governor. The new Governor is actually the old Governor. I have been reappointed until the end of 2004. In order for this to be possible under the CBBH Law, the Government of BH has accorded me Bosnian citizenship, which I regard as a great honor.

In addition, the Presidency and the CBBH Board have already agreed on and appointed the person who will become Governor from 1 January, 2005. He is Kemal Kozarić, one of the current Vice Governors.

The decisions taken by the presidency on the CBBH are very positive because:

- They were taken early thus avoiding any uncertainty;
- They provide a high degree of continuity in the management of the CBBH;
- They have looked well ahead, thus assisting a smooth transition to the new Governor in 2005.

Banking sector

The second area I want to focus on in my address is the commercial banking sector. BH has an improving banking sector. The reform in the banking sector has gone further and faster than reform in any other sector of the economy. Confidence has come back and depositors are now prepared to put their savings in the banks rather than keep them at home in foreign cash under the mattress. Bank lending also grew very rapidly last year and is continuing to rise strongly this year, though at a somewhat slower rate.

The strong growth in bank credit led the CBBH in June, 2003 to take its first ever monetary policy action. The only monetary policy instrument the CBBH currently has is a reserve requirement that we apply to commercial bank deposits. A reserve requirement has been in place since we commenced operations in 1997. But we made a number of significant changes to the way in which it was implemented in June:

- The reserve requirement had previously been applied only to KM deposits. It is now applied to all deposits, thus more than doubling the base.
- Banks could previously meet their reserve requirement either by holding KM banknotes in their vaults or having KM deposits at the CBBH. Now, the reserve requirement can only be met by deposits at the CBBH.
- Previously, banks' excess deposits at the CBBH were not remunerated. Now, the CBBH pays an overnight interest rate on banks' total deposits at the CBBH.

- The ratio level was reduced from 10% to 5%. But because of the other changes, the effect of this was an increase in the level of reserve deposits banks had to hold at the CBBH.

Competition in the banking sector is now very real, helped by the arrival of some good foreign banks. Proportionately, foreign investment in the banking sector has been higher than in any other sector in BH.

Table 5
Commercial bank deposits and lending
Annual percentage change

Date	deposits			lending		
	Business	Households	Total	Business	Households	Total
Dec98	26	63	21	13	105	20
Dec99	18	-9	10	2	8	-5
Dec00	-3	29	8	3	43	8
Dec01	26	177	69	1	77	11
Dec02	9	12	13	4	114	28
Sept03	10	11	12	8	30	15

Bank interest rates on lending have fallen substantially under the pressure of increased competition, but are still relatively high. Comprehensive data on interest rates was not collected prior to 2002 but most bank lending rates prior to 2001 would have been over 20%. They have fallen steadily since that time and the average short term lending rate in August 2003 was 10.43% and the average long term lending rate was 9.33%. June this year was the first time that this interest data shifted into single digit interest rates since we started collecting the data. I expect this downward trend in interest rates to continue.

I will briefly list the main changes that have brought this improvement in the BH banking sector about:

Payments system reform

The cash payments system has been unified with the KM becoming the dominant, and almost the sole, currency in use in BH. In the non-cash payments area, the old state-owned centralized system that had a monopoly was closed in early 2001. It has been replaced with a modern European-type system with two clearing houses, an RTGS one and a giro one, owned and operated by the Central Bank. Payments are being conducted by the commercial banks. The suppliers we used had put similar systems into place in nine other European countries. But it was done more quickly in BH than anywhere else showing that it is possible to implement large, technical projects in BH successfully. It has been operating smoothly and effectively since 5 January 2001.

Minimum capital requirements

These requirements have been substantially increased through a series of steps from an initial KM 2.5 million to KM 15 million from the beginning of 2003. This has forced banks to merge or find strategic partners. This, plus increased competition, has led to a sharp reduction in the number of banks in BH. In 1997, there were 76 registered banks in BH in 1997 but most of them were extremely small. At present there are 38 registered banks in BH. But consolidation with the BH banking system has already gone further than this number indicates. For example, around 65% of total deposits are already in the four largest bank groups and the largest 10 banks have around 85% of total deposits. The number of registered banks will therefore reduce further over the next year as consolidation continues.

Inter-entity banking

It became possible in 2001 for a bank registered in one entity to operate branches in the other entity. Most of the larger banks are already doing so and more will follow. We can say that in the banking sector, BH now has a single economic space.

Deposit insurance

A deposit insurance scheme was started in 2001. It covers deposits in approved banks up to KM 5,000. This is also helping return citizens' confidence to the banks that qualify. Initially, two agencies were established, one in each entity. But in 2002, they were merged into a State Deposit Insurance Agency. At present, 18 banks have met the standards required to be a member of the DIA. But all banks will need to meet these standards in the near future or face the risk of losing their banking license.

Foreign banks

A number of foreign banks have commenced operations in BH, particularly in the last two years. Increased foreign competition has already been very good for the BH economy. It has given depositors more choice and it has forced the local banks to improve the range and quality of the services they provide in order to survive.

Privatization of government owned banks

Progress in bank privatization was initially very slow but accelerated markedly in 2002. The process of privatization is now complete in the RS but there are still some small state-owned banks in the Federation.

These latter two trends, foreign entry and privatization, have led to a substantial shift in ownership in the BH banking sector towards private ownership and, in particular, foreign private ownership.

Table 6

Capital structure in BH banking sector (%)

	31.12.00	31.12.01	31.12.02	31.6.03
State capital	47	19	10	10
Private capital:	53	81	90	90
Domestic	na	25	23	23
Foreign	na ¹	56	67	67

¹ The data isn't available but the % of foreign ownership would have been low.

In short, the BH banking system is looking more and more like the banking system you see in other European countries. The BH banking system has still not completed its transition to becoming a modern European type banking system but it is well on the way and I think most people will be surprised by how quickly the banking system will continue to change and improve. The main things that will slow down the transition are problems in the legal and regulatory frameworks in BH that make it difficult for banks to take and use collateral for lending. This is where the reform focus now needs to be concentrated.

Future initiatives in the BH financial sector

BH now has a sound central bank and a stable currency and a rapidly improving commercial banking sector. Now that the BH financial system has a firm base, the challenges for the next two years are to maintain financial stability and to develop the capital and securities markets so as to broaden the range of financial services available to savers and investors in BH. I will briefly list some of the initiatives that are underway:

National capital markets council (NMC)

I have recently formed a NCMC in order to develop a broadly based strategy for the next stages of financial market development in BH. The Council includes representatives from state and entity governments, regulatory authorities and market participants. All organizations that I invited to join agreed to do so and are participating enthusiastically. This is a very positive start for the process of capital market development.

Sovereign credit rating

The Council of Ministers has decided that BH should seek its first sovereign credit rating and has asked the CBBH to administer the project. The credit rating should be available by April, 2004. The present international perception of BH is often very negative. We believe having a published rating will improve the knowledge about BH and the perceptions many potential investors currently have.

Securities market

Work is currently underway to draft a Securities Law and to develop selling, registry and settlement processes for a securities market in BH. It has not yet been decided whether the first securities will be issued by the State Government, the entity governments or the CBBH - or all of them. But the legal and administrative work will be done to allow any or all of those organizations to issue securities in 2004.

Stock exchanges

Two stock exchanges have been established in BH but both are very small. This is the case with most of the stock exchanges established in the region. The positive development is that seven of the eight stock exchanges in fry have entered into a data sharing program. At its launch they said that this is just the first step on the way to shared trading. There is apparently interest in joining this group from some stock exchanges outside the fry region. So the exchanges are moving towards some form of regional stock exchange, which in my view is the only feasible and sensible option for BH and the other countries in the region.

Banking supervision

Banking supervision in BH is based on the Basle principles. Banking supervision is currently carried out by entity agencies, with the CBBH having a coordinating role. There is good cooperation among the three institutions and this was recently formalized by the signing of a memorandum of understanding. The banking system in BH is now essentially a single country-wide system. Because of this, banking supervision is likely to move under the umbrella of the CBBH during 2004.

Harmonization with the EU standards and regulations

In all areas in financial market developments (as in all other areas), we are trying to ensure that the things we introduce are consistent with EU standards and regulations.

The economic outlook

There are two things that make it difficult to predict the economic outlook in BH with precision. The first is that BH is going through so many transitions simultaneously that the economic numbers can move through very large ranges. Second, the economic outlook depends crucially on an acceleration of the economic, regulatory and legal reform processes in BH. Forecasts based on the status-quo as compared to those based on an accelerated reform path will be very different. In fact, unless the regulatory, legal and tax systems are changed, and changed quickly and substantially, BH will have a very difficult future.

The environment for private investment has improved but it is still far too complicated. This applies to local as well as foreign investment. This is where the attention of BH politicians and international consultants and advisors needs to be directed. The macroeconomic situation in BH is a stable one. It is the areas of regulatory, tax and legal system reform that will determine the future of BH.

I am an optimist and believe that we will see a combination of continued macro-economic stability and accelerated micro-economic and legal reform. On this basis, I would expect inflation to remain stable at around current levels, economic growth rates to be at least 6-7 percent per annum in nominal terms (5% real) and the Balance of Payments situation to gradually improve.

There are still risks attached to investing in BH. But there are also many opportunities. Though BH is a small country, it is very strategically located with free market access to a very large European market. It has a well educated labor force. Given these two factors and the high degree of macro-economic stability in BH, I believe the balance between risk and opportunity now favors opportunity. I take your presence at this conference as a very encouraging sign for BH.